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# **Addressing the Rationality of ‘Irrational’ European Responses to the Crisis: A political economy of the Euro area and the need for an alternative framework for economic policy**

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## **Abstract**

Although the analysis of the contemporary crisis in Europe has many different aspects, this paper will limit its scope to the issue of economic policy. The euro is not just a currency – it is a mechanism. Its introduction has established a particular form of symbiosis among different capitalist economies. The project of euro must be grasped in systemic terms: this mechanism amounts to a particular organization of economic strategies and forms of political power. It is therefore meaningless to criticize the putative irrationality of the policies implemented; it is necessary, rather, to unmask their innate social logic. Mainstream economic discussions focus on the problem of moral hazard and set it as a fundamental strategic target of policy making. In the context of the contemporary version of euro area, this emphasis leads to policy making regimes in which austerity is the only way to deal with economic imbalances. In other words, austerity is offered as alternative to economic instability. What is urgently needed is a progressive prospective on policy setting that overrides this unfortunate trade-off. The paper will address this issue from the viewpoint of (international) political economy.

**Keywords:** Euro zone, crisis, international political economy, financial imbalances, anti-austerity.

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on International Relations, 18-21 September 2013, Warsaw.*

## 1. Introduction

Half a decade has passed since the subprime market financial meltdown, which was the onset for the Euro Area (EA) crisis. The European project has been entered its second, less optimistic phase. The stylized facts of the first phase have been widely discussed during the last years, not always in an illuminating or coherent way. Cross-country differentials in growth and inflation, persistent current account (or financial account) imbalances, real effective rate appreciation (mostly for countries with current account deficits), and the setting up of a leveraged and highly integrated banking system were the most striking developments. For those who have followed the past debates about the crisis of the ERM (Exchange Rate Mechanism) of the European Monetary System (EMS),<sup>1</sup> all these events may give a feeling of *déjà vu*; nevertheless, both the protagonists and the stage (the institutional framework) are different this time, although we have not seen the final act yet. Given the character and the long history of the euro project and given its nature as a mechanism for organizing the interests of capitalists, anticipating its demise is not a safe bet. Nevertheless, it is also obvious that the same project has lost its historical momentum.

The EMU (European Monetary Union) is a *sui generis* monetary union: one without a central authority possessing the typical characteristics of a capitalist state. Two other points about the EMU are also worth mentioning. First, the EMU sets up a context of symbiosis that elevates default risk to secure austerity. Second, it must rely on the elimination of moral hazard as the only way to let different capitalist formations be governed according to the neoliberal agenda, aggressively promoting thus the interests of capital. Official responses must not block the functioning of financial markets, even during the crisis; they must exist only with the status of complementarity to markets (see the analysis in the Appendix and also Sotiropoulos *et al* 2013).

The paper revisits and challenges the theoretical roots of the mainstream political responses to the crisis. It also sets the background for the discussion of an alternative anti-austerity context. This debate is crucial since Europe is in the midst of an institution building process.

## 2. The two narratives about the crisis: a context of discussion

The two different viewpoints about the crisis can be presented with the help of the following balance of payments identity. To simplify things, we shall assume that current account balance  $CA$  is identical to trade balance ( $NX$ ).

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<sup>1</sup> See Sotiropoulos (2012) and Sotiropoulos *et al* (2013; Ch. 6 and 10).

$$Y - (C + I + G) = NX \equiv CA = S_H + S_F + PB \quad (1)$$

Let us focus on the right side of the identity.  $S_H$  is the net savings of households,  $S_F$  is the net savings of firms and  $PB$  is the public budget, which is in turn the net savings of the public sector. Net savings are equal to net capital outflows which increase residents' holdings of foreign liabilities. It is obvious that if net savings become negative, this amounts to net capital inflows from abroad.

### 2.1 The post-crisis official narrative: the case of reflective causality

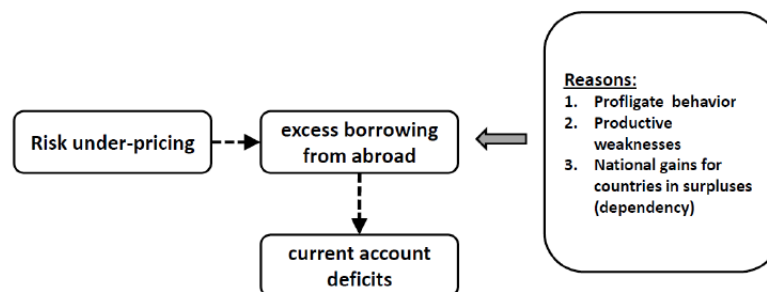
The post-crisis official narrative argues that when an economy faces current account deficits (or reductions in its surpluses), it is a sign of 'imprudent' and 'reckless' domestic behavior both of private (firms and households) and public sectors. In this sense, the EA current account imbalances are a 'bad' macroeconomic development and must be corrected. It must be emphasized that the pre-crisis official explanation of the very same phenomenon was radically different. Current account imbalances were welcomed as the optimum means to support and accommodate the catching-up process between the European 'core' and 'periphery.' Relevant and further reasoning on this discontinuity in the official narrative can be found in Sotiropoulos et al (2013: 184-6). However, just to highlight the point, even in March 2008 Trichet, the ECB president, ensured that "the fundamentals of the euro area economy remain sound and the euro area economy does not suffer from major economic imbalances" (cited in Mayer 2012: 100).

The post-crisis official narrative gradually targeted the economies in deficit as solely responsible for the imbalances because of private sector *dis*-saving, public sector *dis*-saving, or both. This is a highly moralistic kind of reasoning, suggesting that these economies are 'profligate', 'reckless' and 'incontinent' living 'beyond their means.' This is the result of a particular reading of the causality in the above balance of payment identity (1): let us say it favors a *reflective causality*. Negative  $CA$  (or  $NX$ ) is seen as aggregate consumption (living standards) that exceeds the productive capacities of the economy ( $C+I+G > Y$ ). This can hold for either of two reasons. Either overborrowing from abroad boosts domestic demand at levels that overtake productive capacity  $Y$ ; or, alternatively, it masks the structural gaps in competitiveness and productivity. In this sense, 'cheap' finance or risk mispricing is the necessary closure of the narrative.

Therefore the suggested cure for the rebalancing of negative current account positions is domestic deflationary policies in the deficit countries (asymmetric

response in the context of EMU). This in turn means curbing of wages and public spending (public benefits) and the privatizations of public goods (fiscal consolidations). Imbalances are 'bad' on the part of deficit countries or at least sub-optimal and therefore attacking interests of labor must be the proper economic response. The resulting policy mix must reflect the neoliberal agenda. Recession is seen as the proper way to bring profligate countries back to the path of economic virtue. We clearly deal here with a recession-led political agenda. The logic is described by Figure 1.

**Figure 1**  
The misinterpretation of the EA crisis



## 2.2 An alternative explanation: the case of a structural causality

An alternative political agenda must be associated with an alternative explanation. This is a crucial political issue and not a hair-splitting debate among academics. The above post-crisis official argument fails to capture the dynamics of contemporary capitalism. This is because it treats the financial side of the balance of payments identity as passive reflection of either the trade balance or the autonomous investment decisions of private and public agents. This is a line of reasoning that neglects the real workings of modern finance.

The alternative explanation must take into account two basic points.<sup>2</sup> First, the financial account has its own autonomy and does not simply fill the gaps of the current account trends. Second, the financial account imbalances create their own dynamics both in surplus and deficit countries. In the case of a monetary area with the characteristics of the EA, the market-based rebalancing is very likely to take the form of a typical balance of payments crisis (because of a sudden stop in financing). This

<sup>2</sup> For a relevant discussion see Sotiropoulos et al (2013). For a mainstream intervention with a similar perspective see Turner (2013).

outcome actual fits to the facts of the EA crisis. Thus, the financial side of the story should not be underestimated, even more so, in an era of significant cross border financial flows. It also gives another dimension to the discussion. Current account imbalances set a vulnerable symbiosis between economies in surplus and deficit. It is a problem whose roots and consequences concern the pattern of economic symbiosis along with the institutions that hold the symbiosis together.<sup>3</sup>

To illustrate the point, we shall reformulate the identity (1) as follows:

$$\text{net capital inflow} = \text{net imports} \quad (2)$$

Causality in this identity is a structural one: It is defined by the dynamics of capitalist development and the way this development is reflected in market experience. In other words, by the way it is represented from the viewpoint of risk. This means that there are no straightforward functional relations between the two sides.

In a historical project like the EA, combining countries with different growth prospects, financial account imbalances will necessarily develop.<sup>4</sup> This is a condition that makes participation in a monetary union appealing to capitalist powers of both less and more developed capitalisms. However, this leaves net imports as the adjustment variable in the above equation. *Ceteris paribus*, net imports (or the trade balance in general) is the factor that is more likely to accommodate the financial flows of capital in the context of catching-up (growth and profit rate differentials) than vice versa. Trade imbalances and REER (real effective exchange rate) divergence were the results of the process of European symbiosis: it is a weakness that pertains to the whole setting and is linked to strong capitalist development in deficit countries.

### **3. On the political importance of the theoretical debate**

The discussion about the causality of the balance of payments identity has important political consequences.

#### *3.1 Reflective causality and the devaluation of labor*

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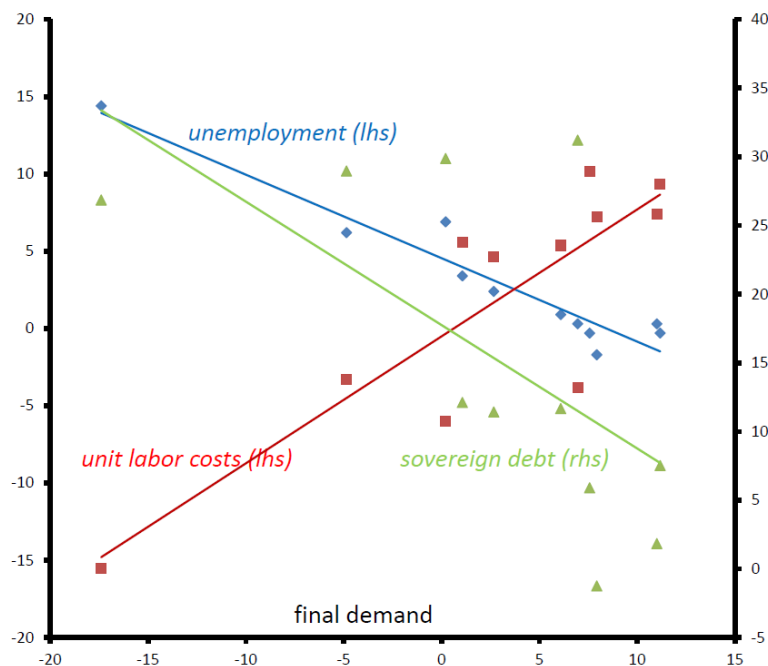
<sup>3</sup> For a more elaborated discussion of the same argument see Sotiropoulos et al (2013), Milios and Sotiropoulos (2010), Milios and Sotiropoulos (2013).

<sup>4</sup> During the pre-crisis period cumulative changes in sovereign debt were usually unimportant (see Appendix). The amount of sovereign debt depends on growth prospects within the EMU and the character of domestic economic policies. Countries with high debt and high growth prospects can easily accommodate tax relief for capital without deterioration in the debt dynamics. This was one of the basic results of the first face of EA.

The argument which sees the financial account imbalances as flexible adjustment to the corresponding trade imbalances, albeit its alternative versions, is in fact a *labor devaluation project*. The macroeconomic rebalancing concerns the economies in deficit which must proceed with some sort of asymmetric adjustments, reducing the international value of labor. More or less this point summarizes the official EA strategy of dealing with the crisis: *recession-led neoliberal reforms*. The primarily asymmetric type of responses which have been implemented so far (the burden of adjustment falls heavily on the distressed economy) are in line with the neoliberal governance of the EMU<sup>5</sup> (emphasis on moral hazard) and they rather use the sovereign debt as a means to austerity (lower taxes for capital and privatizations) and devaluation of labor (better conditions for capitalist exploitation). In this sense, they are economic policies which are genuinely designed to miss their declared fiscal targets but retain as strategic horizon the 'sustainable' reorganization of the economic and social life to the benefit of capital. This is the message of Figure 2. It depicts the changes of the last three years (the numbers for 2013 are estimations) in unit labor costs, sovereign debt and unemployment for the economies of the EA (except Luxemburg). What is presented by the state and European officials as a story of success is actually as story of disaster.

**Figure 2**

Changes in (nominal) unit labor costs, sovereign debt (per cent of GDP) and unemployment in relation to final demand for 2010-2012, EA countries



Source: AMECO database (my calculations; data for 2013 are estimations)

<sup>5</sup> For an exposition of the argument see the analysis in the Appendix.

Economic recession (reduction in final demand) is used as means for imposing favorable conditions of capital valorization (it reduces unit labor costs and REER and boosts exports in relation to imports – the ultimate end is to reshape the social conditions of labor reproduction), but it increases debt and unemployment. At the same time, debt overhang is also used as means for fiscal consolidation and further neo-liberalization of the capitalist state. In a midst of a recession, a country with a current account deficit cannot put its sovereign debt on a sustainable track by solely relying on labor devaluation and fiscal consolidation: these actions will not be sufficient to generate sovereign net savings and reduce borrowing costs. A possible current account rebalancing based on asymmetric responses by a deficit country will extend over a long period. This means a prolonged period of recession or poor economic growth, which will also be associated with a severe deterioration in the living conditions of the population and the quality of the democracy. This is not so much a re-adjustment but a conservative social reshaping led by an authoritarian state interference.

European governments and the ECB have been proved unwilling so far to do 'the right thing in time' in order to decisively mitigate the consequences of the crisis. There are institutional limitations but this is a poor excuse and it downplays the important room for policy actions which still exist even within the current context of EMU. As we discussed above, it is a mistake to interpret this behavior as 'irrational' or 'short-sighted.' The drastic intervention into the crisis would undermine the usage of debt overhang and economic recession as tools for the devaluation of labor. It would undermine the strategic rule of moral hazard as a governance model to the benefit of capital since it would create the real 'hazard' of blocking austerity and neoliberal reforms. It is exactly this event that from a class point of view must be considered as irrational for the capitalist power.

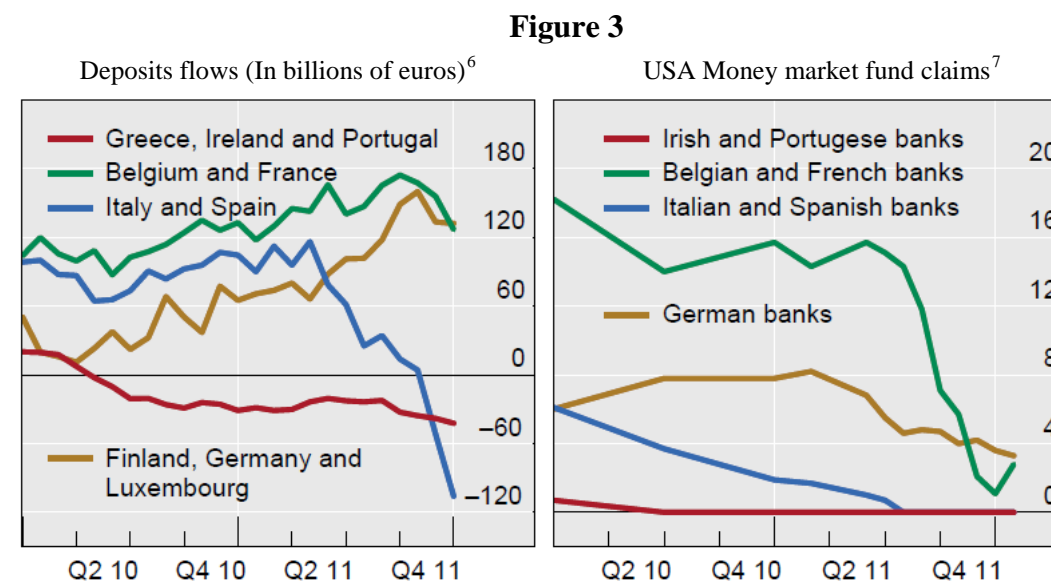
Without going into details, what we should expect in the near future is the application of the same rule: policy responses always one step behind from the workings of markets. Despite its contradictions, this process can secure the final target of European capitalism: the formation of the 'white Chinese worker' in the EU. Possible future plans and financial innovations (banking union; debt restructurings, buy-backs and write-offs; redemption bonds, safe bonds, or even Euro bills etc.) will not be designed as solutions to the misery of the working people but will just serve this single strategic scope. The real issue in the European crisis is not the contradiction between North and South, nor that between debtors and creditors but the fundamental contradiction in capitalism: the one between capital and labor.



### 3.2 The single currency with the different tiers

The agenda of recession-led reforms has generated different tiers within the same currency area. This is the ultimate consequence of austerity: *different euros according to the particular economic geography*. It is not by chance, that the hardcore proponents of extreme austerity even fantasize a return to the national currencies.

Figures 3 and 4 below highlights the major financial developments at the macroeconomic level. In brief, different financial conditions in different parts of the EA have generated different borrowing costs and banking conditions. This is quite obvious in the case of ECB bond purchase program and liquidity provision (co-opting banks into securing funds for fiscal distressed governments): liquidity seeks for safe havens, eventually flowing to the core economies as it is obvious from the deposits drain and the cumulative TARGET2 imbalances.



Source: BIS (2012)

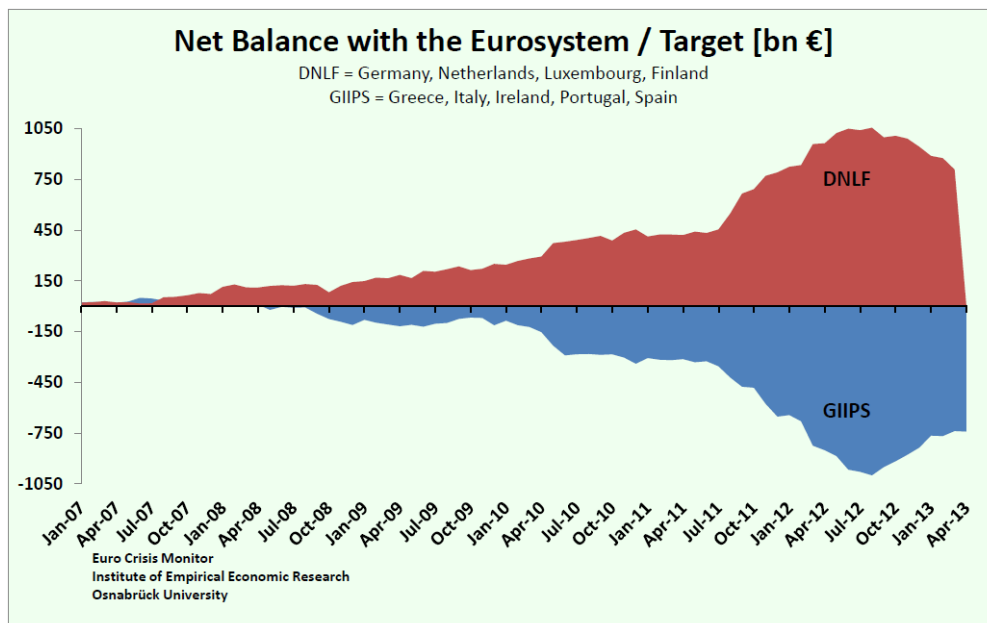
The different tiers within the EA undermine the results of the ECB monetary interventions (which are very cautious, indeed: ECB is more concerned with the issue of moral hazard, which is the cornerstone of the European governance model see Appendix). This is illustrated in Figure 5 which shows the relationship between the growth of domestic demand in the past three years and fiscal austerity. Core EA economies with less vulnerable financial and banking sectors (or with national central

<sup>6</sup> Cumulated inflows of deposits from households and private non-financial companies ver the preceding 12 months.

<sup>7</sup> Claims on euro area banks of the 10 largest US prime money market funds as a percentage of their assets under management. At end-2011, these 10 funds held \$644 billion of assets and all US prime money market funds held \$1.44 trillion of assets.

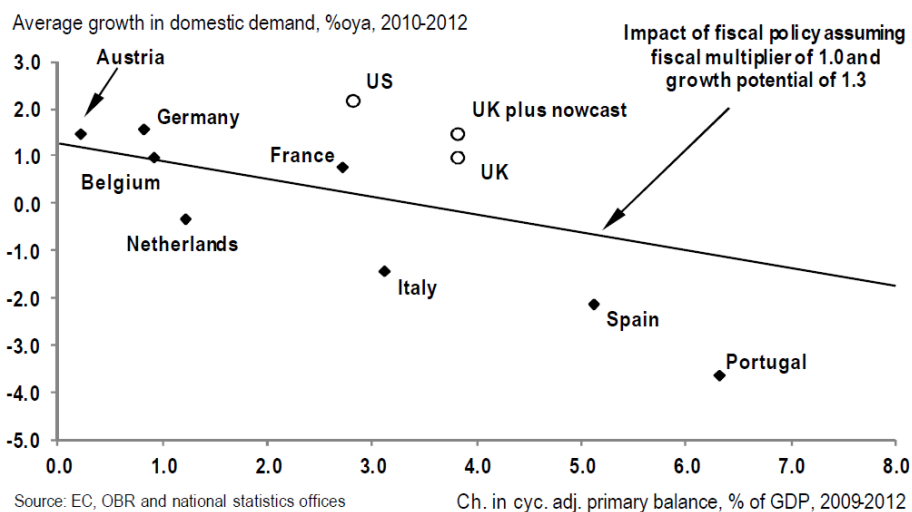
banks) are close or above the benchmark line that presents a fiscal multiplier of 1.0. On the contrary, countries with greater financial and banking distress (the countries of European periphery and Netherlands) have seen demand perform more poorly than would have been expected on the basis of fiscal policy alone. This fact highlights the direct and indirect effects of financial stress on the size of the fiscal multiplier and demonstrates the co-existence of different euros within the EA. ECB monetary policy is not expansionary enough and it is implemented in a context that undermines its effectiveness having significant effects on demand growth.

**Figure 4**



**Figure 5**

**Change in cyclically adjusted primary balance and average demand growth 2009-2012**



Source: JP Morgan, Europe Economic Research, 28 May 2013.

### *3.3 Structural causality and the need for an anti-deflationary agenda*

The agenda of depression-led reforms across Europe is based on a wrong theoretical explanation of the crisis. It is political project that gradually reshapes the economic and social context of the EA to the benefit of capital: it totally reorganizes the conditions of reproduction of labor power. In doing so it creates different monetary tiers within the EA: different geographically specified euros. It thereby undermines what it claims to be its basic target: the unity and singularity of the common currency.

The anti-austerity agenda needs an alternative theoretical explanation from the orthodox one, that emphasizes the financial character of contemporary capitalism. It sees EA contradictions as a result of a particular form of symbiosis and it addresses the problems on the European level. It sets forth an agenda that defends a symmetrical expansionary adjustment that destroys the different tiers within the EA. It is not just another technocratic suggestion but a different perception of the economic policy and the responses to the crisis.

The paper will not get into the technical details about alternative plans. It will close with an observation from the historical past of the European continent. Let us recall Polanyi's (2001) major insight as it was expressed in 1944. In a historical context bearing many similarities to the contemporary one, he argued that liberalism, when in crisis, needs a kind of 'conservative interventionism' in order to reproduce itself. I believe that Polanyi's insight still holds its strength. In our era, capitalist states do not seem so helpless, not even the European ones. They intervene in a decisive manner to restore the dynamics of the markets and to finance the building up of mechanisms and institutions to further squeeze social incomes and public benefits (reshaping the terms of the reproduction of labour power). The resulting situation seems to be that of a free economy under a strong government (or strong governance in the case of EU), as Polanyi might have put it. The key target of contemporary capitalist strategies is the subordination of the stability of employment and incomes to the successful functioning of financial markets. An unstable and dichotomized social regime seems to be the fruit of this process. However, this 'authoritative' type of intervention obviously indicates that there are many different solutions to the debt overhang. The conservative state intervention does not cease to be an 'intervention' inventing all the necessary mechanisms and institutions that may be used for a different policy mix.

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## **Appendix: the EA as a sui generis monetary union<sup>8</sup>**

A single currency area is not identical with a zone of fixed exchange rates. One usual mistake in the relevant discussions is the following: many scholars seem to think that Euro Area (EA) states just peg their national currencies to the euro as if the latter was a mere foreign currency. This assumption usually leads to the most grotesque explanations. Nevertheless, the euro *is* the national currency of every member state of the EA. It is a national currency of a peculiar kind. It is a currency without traditional central banking. And this is a major change, at least for the bigger economies of the EA (such as Spain or Italy). In what follows we shall explain the logic of this unique situation. In particular we shall explain why:

- The EMU (European Monetary Union), by imposing more discipline to the neoliberal project, has become more vulnerable to crises (elevated sovereign default risk); and,
- The emphasis on “moral hazard” is so crucial for the neoliberal agenda in the context of EMU.

### **A.1 More discipline in exchange for more instability: the dangerous trade off in the case of the euro**

In the usual nation state setting, a single national fiscal authority stands behind a single national central bank. In plain terms, this means that “the combined fiscal-financial-monetary resources of the fiscal authority and the central bank must be sufficient to provide the central bank with the resources it requires to fulfill its role as lender of last resort and market maker of last resort and to meet its macroeconomic stability objectives” (Buiter 2008: 9). As we know, this is not the case with the EMU: there is no solid and uniform fiscal authority behind the European Central Bank (ECB). Member states issue debt in a currency which they do not control in terms of central banking (they are not able to ‘print’ euros or any other type of currency, at least not for a considerably long period of time<sup>9</sup>). In this context, governments will not always have the necessary liquidity to pay off bondholders. Financial stability can be thus safeguarded only through fiscal discipline, i.e. through preserving fiscal policies within the neoliberal corset.

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<sup>8</sup> This section draws heavily upon Sotiropoulos et al (2013; Ch.10).

<sup>9</sup> Under the Emergency Liquidity Assistance (ELA) – integral part of the European System of Central Banks – national central banks can in exceptional circumstances provide liquidity (against collateral) to distressed credit institutions under terms which are not publicly disclosed. During the recent crisis this liquidity channel was put in motion with the cases of Germany and Ireland as the most indicative examples.

This should not be taken as a real sacrifice on the part of sovereign states. On the contrary, it is considered as a welcome condition for the organization of neoliberal strategies, because *the disintegration of the welfare aspect of the state is now the only route to financial stability*. Nevertheless, this institutional arrangement comes with a serious cost, a danger that the old discussions with regard to the EA strikingly underestimated. The economies of the EA have voluntarily subjected themselves to elevated default risk.<sup>10</sup> Let's focus for the moment on this particular question.

When a government with a large amount of foreign-currency denominated sovereign liabilities faces a change in the “mood” of the markets<sup>11</sup> – that is, a re-pricing of risks associated with its assets and liabilities, possibly expressed as a sudden freezing of the inflow of capital (a liquidity crisis, let's say) – it will experience an explosion of debt servicing costs on the foreign currency and the derailment of its budget balance. This is bad news for debt sustainability (and financial stability). The government must immediately tighten fiscal policy in the midst of a recession (an economic recession is likely to be the result of such risk revaluation since the terms of state borrowing reflect the terms of private borrowing), communicating to the markets its ability and willingness to continue servicing its foreign debt. The government has to convince the markets that it can secure a social consensus to the neoliberal corset; or, in other words, policy makers must ensure that they can impose fiscal prudence in the way markets dictate it, according to the mainstream line of reasoning (securing the interests of capital). Such policies, in the midst of a recession, are not unlikely to lead to a severe crisis. In the case of a monetary union like the EA, the significant financial interconnectedness of the member states raises fears of contagion which is also reflected upon the distressed governments. As mentioned many times in the relevant literature, this is a vulnerable macroeconomic setting, prone to a self-reinforcing and self-fulfilling type of sovereign debt crises.

For European citizens this story might well give a sense of *déjà-vu*. It bears a striking resemblance to their current condition. The example of a state with a large debt in a foreign denomination resembles (but it is not identical to) the fiscal conditions of the EA.

Things would not necessarily be this way if the economies of the euro zone had not abandoned their former national currencies. In this hypothetical case, a *moderate* exodus from the government bond market would cause a manageable devaluation in the exchange rate without undermining the liquidity conditions of the economy. Foreign investors would get rid of the sovereign debt but they could not

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<sup>10</sup> For this argument see Kopf (2011: 2).

<sup>11</sup> At this stage of our analysis we are not interested so much in the roots of this shift in the perception of markets.

take the national currency equivalent with them. Financial intermediaries with foreign debt would feel some pressure but the quantitative easing window (i.e., according to the contemporary expression, the printing of money) put forward by the central bank could alleviate the pressure thus satisfying the liquidity preferences of the financial sector. But even in the extreme case of financial distress, the national central bank could simply ‘print’ money (this is a notional electronic transaction), thereby lending directly to the government in order to prevent sovereign default. We have to note that this is one possibility among others and holds mostly for the larger economies. This possibility is not so strong in the case of smaller economies (like Greece, Ireland and Portugal).

By adopting the euro as their new common currency, the participating countries (i.e. their ruling classes) have made a ‘dangerous’ choice. They have voluntarily curtailed their capacity to deploy meaningful welfare policies, subjecting themselves at the same time to a high degree of sovereign default risk. This has turned out to be a risky trade off. A moderate exodus from the sovereign debt market (i.e. a moderate risk re-pricing) now distorts the liquidity conditions in the economy and leaves the state with only one path: fiscal tightening, high interest rates, recession, debt un-sustainability, crisis, and default. Economies that face liquidity problems in their sovereign debt markets may not go all the way down this path (given the policy responses at a European level) but, in any case, recessionary policies are the only route suggested by the existing shape of the EA. If sovereign states are massively caught by the unfortunate spin of this vortex, *crisis is just the other way to implement the neoliberal strategies*, more unorthodoxly and violently this time. European states have voluntarily placed themselves in a predicament where markets can actually force them into default but this is an issue within the European policy setting.

## **A.2 EMU and moral hazard: the triumph of neoliberalism**

We have seen so far how the states of the EA have subjected themselves to a high degree of sovereign default risk. This was a development underestimated by the architects of the euro. On the other hand, a much more frequently discussed issue was the restriction of public debts. We shall not go through all the discussions that gave birth to the so-called Growth and Stability Pact. We shall just focus on its principal logic.

We have to stress once more that as regards the disciplining of state policies to the neoliberal corset the key-issue is not the level of public debt or deficit but the way markets interpret the connection of these fiscal variables with the other crucial parameters of debt dynamics (growth rate, interest rate, primary balance). Hence, the disciplining process contains two crucial moments: the whole configuration of debt

dynamics *and* the pricing of involved risks by markets (which, of course, is based on a particular representation of reality given the institutional background). It was pretty obvious from the beginning that the context of the euro could possibly ‘confuse’ market supervision, making room for potential fiscal expansion contrary to the dominant neoliberal spirit. There are several reasons for this, some more important than others. For one thing, European bank regulation put a zero capital charge on all EU sovereign debt, prefiguring the subsequent narrowing down of interest rate spreads. This means that commercial banks could borrow in the wholesale market at Euribor and then buy European sovereign debt, gaining the spread as risk-free profit. The return on this carry trade was extraordinary, pushing the market to underestimate some of the risks involved in the sovereign indebtedness. We could mention more examples.<sup>12</sup> For instance, the ECB lent cheap to the commercial banks, accepting sovereign bonds as collateral with the same quality. In other words, the ECB justified by its actions the negligible risk differentials.

But the basic issue was that markets, being aware of the financial interconnectedness within the EMU, felt sure that no country would be left to default since such an event would have wider economic implications for the EA. Indeed, until 2008, the markets put all sovereign debt pretty much on the same footing, narrowing down the spreads. Of course the difference in the interest rate spreads cannot be solely explained in terms of institutional reasons. Long term interest rate spreads also capture the overall country specific risk: that is, the growth prospects within the particular institutional setting. In this sense, the convergence of the long term interest rates of Greece and Germany reflects the growth differentials when the latter are considered within the context of EA.

Nevertheless, this seems like a serious limitation to the disciplining mechanism of markets. To use market language, the context of EMU also elevated the risk of moral hazard. Without some ad hoc regulation, there were not enough incentives either to prevent governments from issuing too much debt or to take the necessary measures to deal with it. This condition *could* be seen as giving some space for the implementation of welfare policies. Nevertheless, it did not. Markets might be unable to supervise the sovereign states ‘efficiently.’ It was the invention of the Stability Pact that was designated to solve the problem. This pact explicitly banned every type of bail out and deprived the ECB of the right to buy sovereign debt on a regular basis. It made the euro an international currency without the backing of a traditional central bank. Moreover it posed an artificial ceiling on the public debt and public budgets: since financial stability was to be secured by fiscal tightening, and since the euro symbiosis would not let markets properly impose fiscal disciplining,

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<sup>12</sup> See Kopf (2011: 4-5).



there emerged the need on the part of capitalist power to politically impose ad hoc fiscal rules and forms of political supervision. Their key-role was to supplement markets in their overseeing duty. If markets were unable to price sovereign risk in the EMU properly, then explicit political regulation would have been necessary to solve this problem by imposing appropriate rules. Nevertheless, when it comes to the relations between sovereign states the strict application of these rules cannot be taken for granted.

In any case, the structure of EMU (market supervision and the Stability Pact) did provide a context for the control of public finances and, aside from some minor violations, succeeded in tightening them in line with the demands of the neoliberal model. This is pretty obvious if we take a quick look at the dynamics of debt. Let  $d_t$  be the amount of sovereign debt at year  $t$ ,  $pd_t$  the primary deficit for the same year (expenditure before interest payments minus revenues),  $g_t$  the nominal growth rate,  $i_t$  the implicit interest rate and,  $sf_t$  the stock-flow adjustment. All these variables are expressed as ratios of GDP. Then from the fiscal balance identity we can easily receive the following equation:

$$d_t = pd_t + \left( \frac{1+i_t}{1+g_t} \right) \cdot d_{t-1} + sf_t$$

The equation can be approximately rewritten as follows:

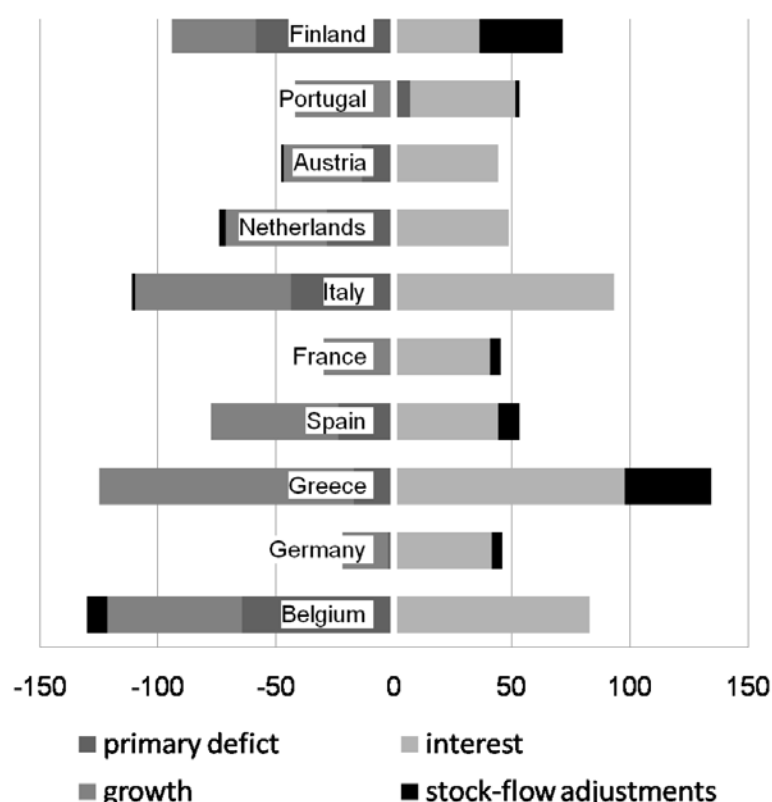
$$d_t - d_{t-1} = pd_t + (i_t - g_t) \cdot d_{t-1} + sf_t = pd_t + i_t \cdot d_{t-1} - g_t \cdot d_{t-1} + sf_t$$

In brief, given the level of debt  $d_{t-1}$  the above expression measures the contributions to the debt dynamics of several factors:  $pd_t$  is the annual contribution of primary deficit (a positive primary deficit adds to the debt);  $i_t \cdot d_{t-1}$  is the contribution of the interest payments (they add to debt);  $-g_t \cdot d_{t-1}$  is the contribution of growth (higher growth means lower debt);  $sf_t$  is the contribution of the stock-flow adjustment. Figure 6 shows the cumulative changes of these variables for the first phase of EA, namely the period 1995-2007 (we exclude Luxemburg from our sample).

Despite the post-crisis official viewpoint, the first period of the EA succeeded in controlling the dynamics of sovereign debt. Even in cases like Greece and Italy, which carried sovereign debt much higher than the arbitrary Maastricht threshold of 60 per cent, the factors that contributed to the increase of debt in each case were (more than) counter-balanced by factors pushing in the opposite direction. For Belgium, another over-indebted case, the total contribution of the above factors was to decrease the debt. All these developments were steadily accompanied by the

implementation of neoliberal policies that favored reductions in public expenditure and promoted tax relief for capitalists and wealthy households. From this point of view, the first phase of the EA was consistent with its own targets: disciplining state policies to the agenda of neoliberalism without putting debt on unsustainable track. Note that for the majority of cases, including the so-called extreme case of Greece, the contribution of the primary deficit was negative (for this particular period European states ran cumulative primary surpluses).

**Figure 6:** Cumulative contribution to debt for 1995-2007 (per cent of GDP)



Source: AMECO database, my calculations.

The official fears that the institutional setting of EMU might give rise to ‘profligate’ and ‘imprudent’ elements in the fiscal policies *were right but in the wrong direction*. The most interesting finding from Figure 6 is the following. For pretty much every country in our sample, positive and negative tendencies to debt dynamics were by and large balanced. This means that overall levels of sovereign debt were not significantly changed. It was mostly the contribution of growth that counterbalanced interest rate payments (in an environment of decreasing interest rates) and made room for neoliberal fiscal policies. In other words, *given the level of growth and the increasingly favorable milieu for interest payments, the debt did not decrease to the*

*Maastricht levels because of neoliberal tax relief to the benefit of capital and wealthy individuals.* Greece is the most indicative example in this line. For Greece, strong growth, combined with the reduction in the borrowing costs, left the sovereign debt ratio intact at the level of 100 per cent for the whole period under examination. The major cause was the shortfall of revenues in relation to the expenditures, regardless the so-called inefficiencies in the state apparatus (which of course are not Greece's prerogative). Figure 7 suggests that this result holds for the other EA countries as well.

Chart 7a suggests that the implicit interest rate, although more rigid than the nominal long term interest rate, hinges heavily upon capitalist growth.<sup>13</sup> This implies that the interest rate on existing debt is endogenous to growth and follows its trend. Higher growth in the context of the EMU was translated into lower overall borrowing costs. Chart 7b has also the expected shape: as a general rule, we see that the higher the growth contribution to the decline of debt, the higher the cumulative primary surpluses. *But this fact was not due to an increase in revenues.* Quite the contrary, it is evident from charts 7c and 7d that higher (cumulative) growth was accompanied by lower (cumulative) fiscal revenues and expenditure. This finding means that higher growth in the context of declining borrowing costs (in the frame of the EA) did not endanger the neoliberal principle of reduction in public spending ('less state') while it *did* gave room for substantial tax relief to the benefit of capital and rich people as is indicated by the lower levels of cumulative revenues. In fact, the EMU setting provided a strong basis for the materialization of the most offensive neoliberal agenda. *If there was any profligacy at all, this was due to the tax relief enjoyed by the top social strata.* From this point of view, those who analyze the recent fiscal crisis in the EA as the result of irrational binge are right, indeed, but for a different reason. There was a binge but the working class was not invited. In that case the rules of *savoir vivre* were broken...

### **A.3 Moral hazard and market discipline**

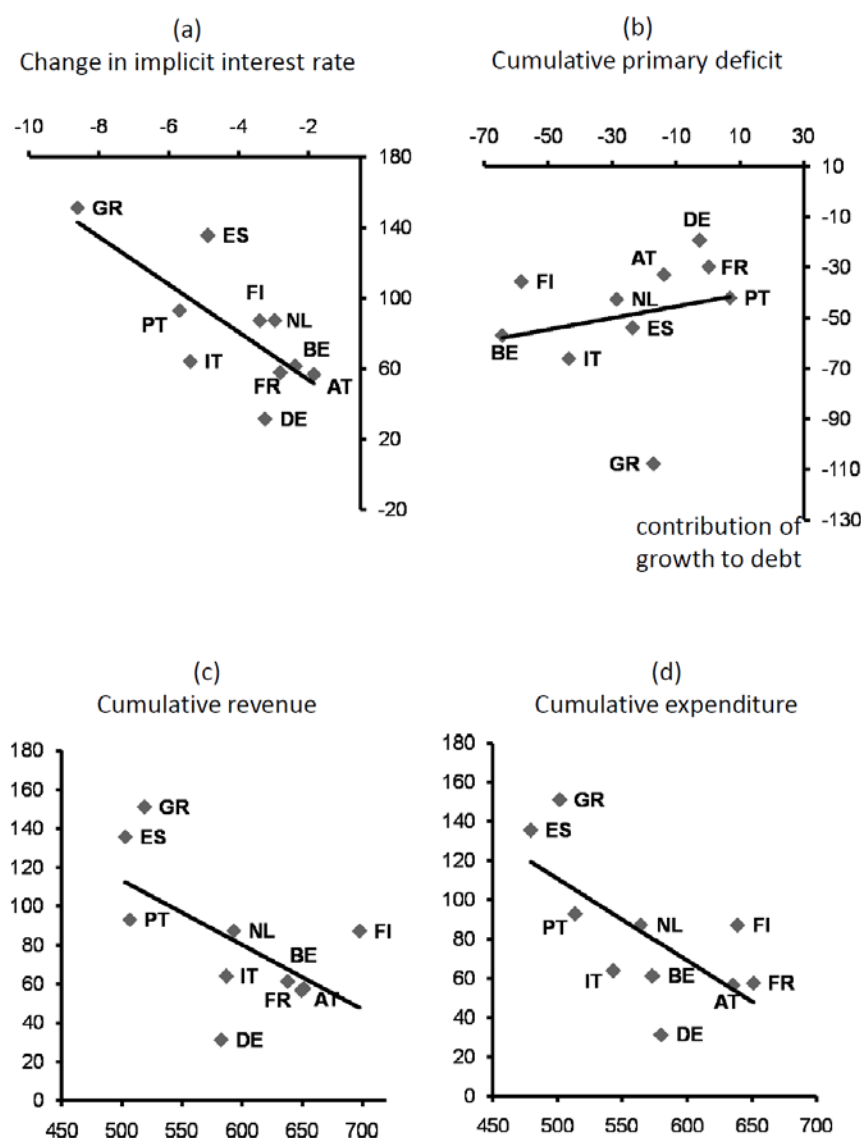
After the start of the 2008 financial meltdown, European officials, along with the participating governments, were faced with a very difficult puzzle: first, how to deal with the enormous economic problems and contradictions without undermining the neoliberal context of the EMU; second, how to create proper policy mechanisms for intervening in the mess, turning the crisis into a chance for further boosting of the neoliberal agenda; third, how to set up new rules to overcome the vulnerabilities of

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<sup>13</sup> Here we treat the group of EA countries as panel. We are interested to isolate the general trend despite the different institutional settings that holds for any single country in particular with regard to sovereign debt dynamics.

the past without negating the conservative edifice of EMU; fourth, how to correct the problems while avoiding the ‘overcorrection’ that would make room for the implementation of social welfare policies in the future; finally, how to use the tremendous fire power of the ECB without turning it into a ‘traditional’ central bank.

**Figure 7:** Factors contributing to increasing indebtedness in relation to growth (or growth contribution to debt, all variables are expressed as percentages of GDP), EA, cumulative changes for 1995-2007<sup>14</sup>



Source: AMECO database, my calculations.

<sup>14</sup> We have excluded Luxemburg from sample. Ireland has also been excluded from a, c and d. This does not change the message of the charts.

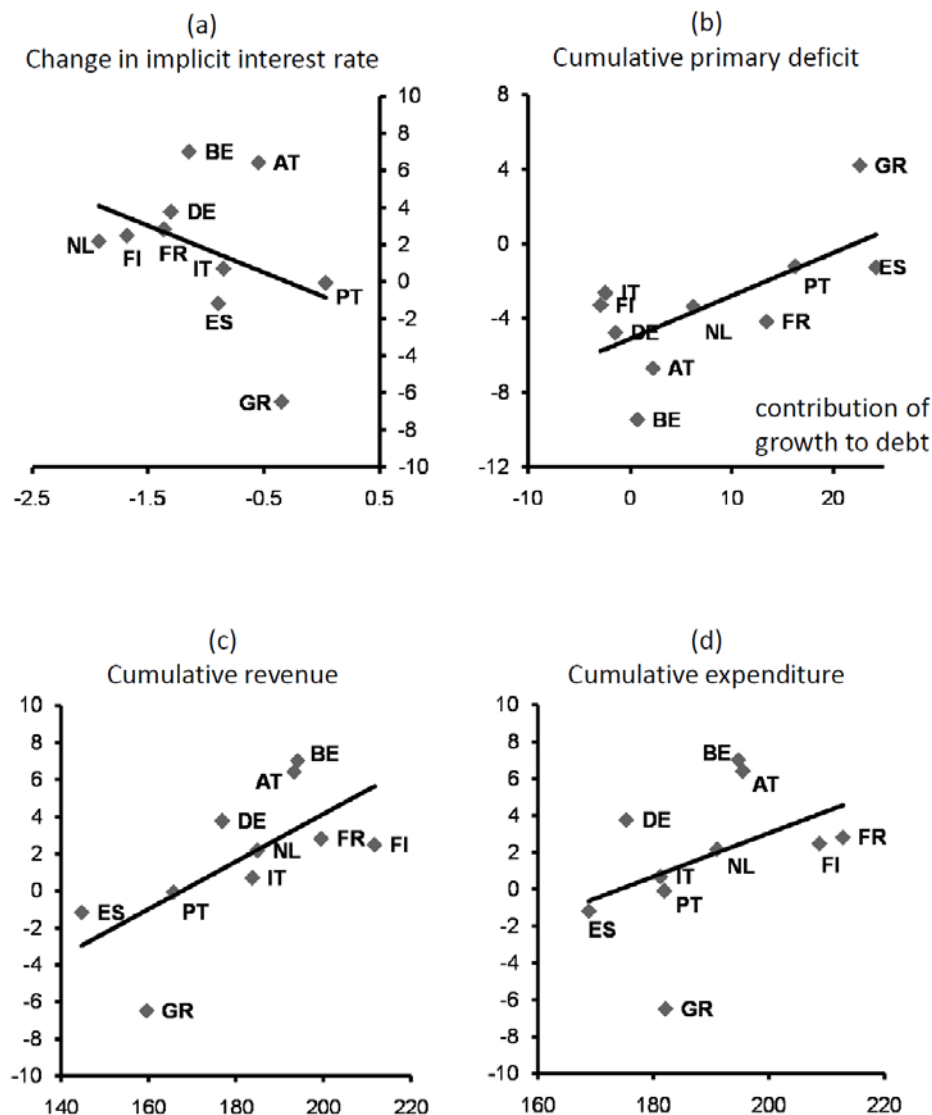
It would be pointless to revisit the episodes of the EU summits or to speculate on what may happen in the near or far future. The European capitalist powers have jointly decided to exploit the current crisis so as to extend the neoliberal agenda. And since the EMU is not an integrated political union, in the light of the above reasoning: *the capitalist responses to the crisis have necessarily to be complementary to the functioning of the markets*. If not, the markets cannot play their disciplining role and the central authorities are unable to mandate the neoliberal reforms. In plain terms, interference with the market in the context of the EA would block or undermine the role of modern finance as technology of power. Figure 8 illustrates this result and it must be read in contraposition to Figure 7.

Of course, the macroeconomic behavior of an economy is very likely to differ with respect to the underlying economic phase. Chart 8a does not imply any radical change in the endogeneity of the implicit interest rate, given of course the shift in the pricing of risk by markets (implicit interest rate responds mildly to the perspective of the markets, since it concerns all the outstanding debt). The same holds for chart 8b. But the explanation for the latter is now very different during the recession years, since the contribution of (cumulative) growth is rather positively linked to (cumulative) revenue and expenditure in charts 8c and 8d. This is exactly the opposite of what held for the pre-crisis years. It justifies the principle of austerity in the context of the EA: the crisis (low growth) is by and large being used as a means to further neo-liberalize state governance. Given the inelastic parts of public expenditure and the lower tax incomes, recession is now approached and used as a tool for further reductions in total expenditure and further relative fiscal burdens to labor. This is the result of the abovementioned type of governance: official responses complementary to the role of the markets. In other words, austerity has been rendered the major economic policy for developed European capitalist formations. Of course, all these observations describe the general trends which depend also on the results of class struggle.

The commentators or analysts who blithely criticize European leaders misunderstand this point. Not only do European officials always have a second and a third plan in reserve, but their decisions must impel the neoliberal agenda without violating the functioning of the markets (to the extent that these decisions comprise a hegemonic plan for all European economies). Otherwise the crisis cannot be exploited as opportunity for capital. In simple terms, aggressive neoliberal measures and reforms would not be implemented in the participating countries if the ECB had worked as a fiscal agent from the beginning, if its intervention in the secondary sovereign debt markets had been deeper and more persistent, if the fire power of EFSF or ESM had been sufficient to deal with the core needs of the sovereigns, if LTROs and OMT were more decisive, if the current plan for Spain had been imposed

on Ireland, if... *The grave character of the crisis might have been avoided but in a totally different direction: one ensuring some protection to the living standards and the labor rights of the working classes.* This would have been a different Europe, though: a Europe promoting less drastically the interests of capital.

**Figure 8:** Factors contributing to increasing indebtedness in relation to growth (or growth contribution to debt, all variables are expressed as percentages of GDP), EA, cumulative changes for 2008-2011<sup>15</sup>



Source: AMECO database, my calculations.

In brief, the European strategy for dealing with the crisis has as its main target the further embedding of the neoliberal agenda. It will always stay one step back from

<sup>15</sup> We have excluded Luxemburg from the sample. Ireland has also been excluded from a, c and d. This does not change the message of the charts.

the 'real' needs of the time so as to lead states onto the path of conservative transformation by exposing them to the pressure of markets. This strategy has its own rationality which is not completely obvious at a first glance. It perceives the crisis as an opportunity for a historic shift in the correlations of forces to the benefit of the capitalist power, subjecting European societies to the conditions of the unfettered functioning of markets. In section 4 we shall discuss how all the already proposed plans fit nicely to this picture. Of course, the future of class struggle cannot be safely dictated...